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## WHY SHOULD HAPPINESS HAVE A ROLE IN WELFARE ECONOMICS? HAPPINESS VERSUS ORTHODOXY AND CAPABILITIES

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# Why Should Happiness have a role in Welfare Economics?

## Happiness versus Orthodoxy and Capabilities

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### Abstract

In this paper we try to understand how the Happiness Literature (HL) approach to Welfare Economics (WE) enriches it by enlarging its scope and power of analysis. To do so, we contrast the HL approach not only with Mainstream Welfare Economics (MWE) but also with the already established Sen's Capabilities (SC) approach. We demonstrate (particularly for the cases of Income and Freedom) that these different theoretical approaches can imply different policy conclusions even when facing the same problems (mostly when switching from MWE to SC or HL) and that these different approaches have different domains of application (SC and HL with a wider domain than MWE). We also claim that the choice between MWE, SC and HL, even when the policy conclusions are similar, is connected with different axiomatic and philosophic foundations (with SC as the sole approach to clearly depart from utilitarianism). We then conclude that HL stands out as an autonomous approach to WE with particular assumptions, techniques and policy conclusions.

JEL Codes: D63; D60; I31; I38

Key Words: Happiness, Capabilities, Welfare Economics, Welfare Policies

### 1. Introduction

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The main purpose of welfare economics (WE) is to assess the welfare consequences of different economic configurations (market vs. central planning, different taxes systems, subsidies policies, laws on international trade, etc.). It is a specific branch of economic analysis where the normative problems are more salient: beginning with a positive analysis (based on economic models), WE ends with policy advices (ex. using some specific economic model, WE states that the economic policy  $x$  is better, in terms of welfare, than economic policy  $y$ ). In the words of Per-Olov Johansson (1991):

A distinction is usually made between analysing the consequences of a change and making judgments concerning the desirability of particular changes or policies. The former kind of analysis is called *positive* economics, while the latter is referred to as *normative* economics. We can use tools such as supply and demand curves to describe the effects of a policy change, such as a proposed tax on cigarettes... , ...These are examples of the kind of questions positive economics is concerned with. On the other hand, normative or *welfare economics* is concerned with evaluating the various consequences of the proposed tax and coming to a judgement concerning the desirability of the tax. Thus, the basic aim of welfare economics is to provide us with criteria according to which various policy proposals can be ranked.

(Johansson 1991)

Simple as it might seem (from the viewpoint of logic) the step from positive towards normative reasoning (from positive economics towards normative economics) is not always easy: even if one accepts the validity of the underlying “positive” model there is always a conceptual and value issue to be solved before some normative consensus could appear<sup>2</sup>.

For Robbins (1981) that is a critical issue, one that could even destroy WE as a science. He believes WE should be relabelled Political Economy at the same time as it would become clear that it is a subjective domain of analysis. For him, it becomes

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<sup>2</sup> Note that it can be argued that a normative consensus will never appear (which is Lionel Robins’ position on WE, shown ahead): dealing with normative and axiomatic issues (such as the definition of welfare or of the “good”) one might be forced to accept the impossibility of an unanimously supported definition.

imperious to make the choice about “what good is?” transparent. Welfare economists must first reveal what’s their conception of the good (which is mostly a subjective issue), and only then use economic models to perform welfare analysis. In his own words:

As regards the subject matter of Economic Science, I adhere to its description in terms of behavior conditioned by scarcity. As regards its status as a science, I see no reason to deny its susceptibility to the usual logical requirements of a science, though I have emphasized the peculiar nature of its subject as concerned with conscious beings capable of choice and learning. I see no reason why we should be terrified into thinking that such analysis necessarily involves ideological bias. But beyond that, in the application of Economic Science to problems of policy, I urge that we must acknowledge the introduction of assumptions of value essentially incapable of scientific proof. For this reason, while not denying the value of some thought going under that name, I have urged that the claims of Welfare Economics to be scientific are highly dubious; and I go on to argue the lack of realism which is involved by some of the inferences which may be drawn from its assumptions. Instead I recommend what I call Political Economy which, at each relevant point, declares all relevant nonscientific assumptions; and I furnish some indications of the leading criteria and fields of speculation which should underlie this branch of intellectual activity.

(Robbins 1981, p.9)

So, even if one disagree with Robbins on the need for WE relabeling, it is clear that the very definition of welfare is critical to build an approach to WE: is it material progress, psychological well-being, freedom (political, economic or social), enlargement of consumption options?

The answer to this question will determine not only one approach to WE but also the type and direction of policy advices.

The conception of welfare within the discipline of economics has a long history of fluctuations and has been subject to some paradigm changes throughout time.

From the classical utilitarian tradition (where the welfare of the society was conceived as the sum of the welfare of all the individuals and the welfare of individuals as the utility they obtained from the goods they had at their disposal) to its later

welfarist version (with utility, inferred from the choice behaviour of rational agents, assumed as ordinal, interpersonally incomparable and as the sole valid informational base for WE<sup>3</sup>) passing through the max-min principle (a neoclassical interpretation of the work of Rawls on justice as fairness where the welfare of society was to be determined through the utility of the most disadvantaged ones), the alternatives purposed by Amartya Sen and John Rawls (capabilities and primary goods, respectively, as competing informational bases for welfare assessments, opposing to utility) and the more recent challenges of subjective assessments of utility (Happiness, Subjective Well-Being (SWB), Life Satisfaction, etc.) WE struggles to reach a “stable equilibrium”<sup>4</sup>.

In practice, Welfare has been alternatively associated with material things (wealth, GDP, income, consumption bundles, basic goods), with a psychological phenomena (happiness, “good” emotions or, more broadly, utility as a subjective concept), with utility as an abstract and psychologically empty concept, inferred from preferences orderings inferred from the objective and observable choice behaviour, or with freedom and capabilities. Each alternative brought specific frameworks of analysis and domains of application (not always compatible or complementary with each other)<sup>5</sup>.

Eventually, out of the myriad of alternatives, some get more credit than others, some are more widely used than others, some are labelled orthodox, others heterodox.

In this paper we will analyse three different contemporary approaches to WE (the orthodox and two heterodox). We will make the case that the three different approaches in contrast have different conceptions of welfare, methods, philosophical backgrounds and, most times, different policy conclusions.

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<sup>3</sup> This is the dominant rhetoric about utility amongst economists and is considered the standard for MWE. Nevertheless it is easy to find discrepancies between the rhetoric and the practice: in many papers where welfare analysis is done (see Laffont and Tirole (1986) as an example) an additive social welfare function (as objective function of maximization) is used. That implies a cardinal conception of utility even if that is not admitted. Furthermore, the Arrow Impossibility Theorem (1951) has shown all ordinal interpretations of utility destructive of any solid social decision rule (and hence, any Social Welfare Function). Even so, many mainstream welfare economists try to avoid SWF and use other tools of WE they believe valid within the ordinal utility framework (see Just et al. (2004) where this line of reasoning is supported within the public policy context) or claim that ordinalism does not destroy SWF (see Fleurbaey and Mongin (2005)).

<sup>4</sup> To a more detailed analysis on the evolution of welfare concepts throughout the history of economics see Bruni (2004a, 2004b); Chipman and Moore (1978); Cooter and Rappoport (1984); Viner (1925); Wolfe (1931); Bharadwaj (1972); Stigler (1950).

<sup>5</sup> Note that stating the evolution of WE as scientific progress might not be correct. Most times changes in WE are such that only new and different questions can be answered, not the old ones. Such changes are not scientific progress but rather an evidence of interests refocusing. See Cooter and Rappoport (1984) on the ordinalist revolution as an example.

As the name indicates, MWE is the dominant view in economics, so are its respective methods and conceptions. Nevertheless, it is frequently attacked (on its theoretical fragilities and ambiguities) by new alternatives that spring constantly. That puts MWE under pressure to adapt or respond with new ideas and models. SC and HL are two of the strongest alternatives.

We will be particularly focused on trying to understand how HL, a new competing approach to MWE, challenges the later and imply revisions on the policy advices WE usually produce. We will also contrast HL with SC as this is an already established alternative to MWE and one that shares with HL several concerns and results (namely policy advices, conclusions and criticism towards MWE)<sup>6</sup>. Furthermore, HL (by its rapid growth and interdisciplinary nature) and SC (by its internal coherence and established reliability) can be regarded as the most threatening competing approaches to MWE.

The final goal of the paper is to show that HL has a room within WE.

This paper has five more sections. Section 2, 3 and 4 will be devoted to briefly framing and contrasting each theoretical view on WE: MWE, SC and HL, respectively. Section 5 will analyse the policy implications each theoretical background brings about. In particular we will investigate those implications on two main areas of human welfare: freedom (section 5.1) and income (section 5.2). Section 6 draws the main conclusions.

## **2. Mainstream Welfare Economics**

There are numerous forms of welfare analysis in economics, not all being compatible or even complementary with each other. Nevertheless, it is possible to find a core of analysis sufficiently integrated and standardized so we might call it Mainstream WE.

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<sup>6</sup> A big difference (which is, at the same time, a linking point between HL and MWE) between SC and HL is, however, important to notice: SC is a non-welfarist approach to WE whereas HL remains within the welfarist tradition (that is, SC stresses the need to use extra-utility information to proceed with welfare analysis while HL (in comparison with MWE) only demands new forms of measuring and new conceptions of utility). See Duclos and Araar (2006) for a distinction between welfarist and non-welfarist approaches.

For the purpose of this work, and to mark a sharp contrast with both HL and SC, we assume MWE to be characterized by the usage of certain tools of analysis, two theorems and the acceptance of some traditional assumptions of mainstream economics. That is, we claim MWE uses the first and second welfare theorems (1<sup>st</sup> and 2<sup>nd</sup> WT), consumer/producer surplus (CS/PS), compensating and equivalent variations (CV/EV), Pareto criterion (PC), compensation principle (CP), cost-benefit analysis (CBA, and other tools for applied WE like survey data, the Clark-Groves mechanism, travel costs and hedonic prices) and social welfare functions (SWF) as the main tools to perform its welfare analysis<sup>7</sup>. Furthermore, it subscribes methodological individualism, consequentialism, rationality principle (perfectly rational, utility maximizing agents), modelization and mathematical formalization as fundamentals for those tools.

The majority of those tools also rely on the validity of the price system as a mechanism for value assessment (in a competitive framework) and on the idea of utility as a subjective, directly non-measurable and interpersonally incomparable reality<sup>8</sup>.

The above mentioned list is large and encompasses different kinds of tools, with different domains of application and analytical power.

In order to make clear what MWE is (in this section) and how HL and SC are different and challenge the former (in following sections) a briefly but detailed description of each tool is necessary.

The first thing to notice is that these tools can be grouped into four different classes, to wit, theorems (1<sup>st</sup> and 2<sup>nd</sup> WT), tools for applied WE (CBA and the others), social decision rules (SWF) and tools based on the rhetoric of ordinal utility (PC, CP, CV/EV and CS/PS). The second is that, although these four classes refer to mainstream techniques, some incompatibilities might be found between them, particularly between SWF and the other tools of analysis in MWE (as will be clear later).

Following appears a description of each tool, starting with the tools based on the rhetoric of ordinal utility and finishing with SWF.

### *Tools based on the rhetoric of ordinal utility*<sup>9</sup>

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<sup>7</sup> This list might not be completely exhaustive but it is representative of MWE's main tools of analysis, as a quick look at contemporary WE textbooks will confirm.

<sup>8</sup> Again remember the usual disparities between the rhetoric and the practice of many economists on their welfare analysis (ordinal rhetoric with cardinal practice).

<sup>9</sup> The tools here analyzed are usually conceived as operational under ordinality of utility. Nevertheless, it can be argued that's not the case for some of those tools, as some form of cardinality is often implicit (even if not recognized by those who use the tools). If that's the case, these tools might be biased towards

PC: this concept is due to the Italian 19<sup>th</sup> century economist Vilfredo Pareto who proposed that in evaluating different social states we could only say that one state is preferred to other if in the later all individuals (or at least one) are better (without anyone being worst off) than in the former.

This concept has a large potential of acceptance because it is very restricting in making value comparisons. It could even be said that this criterion is obvious and intuitively correct. It seems hard to figure out what could go wrong for the state where all individuals are better off not to be preferred to the previous where all were worst off.<sup>10</sup>

This concept entered the core of WE in the form of Paretian Efficiency according to which one state is only considered efficient when there is no possible resources reallocation that can improve the welfare of some without harming the welfare of others. Appealing as this can be, this might be a very restrictive and limited criterion. It has no power whatsoever to help WE in analysing situation in which we deal with welfare gains for some and welfare losses for others (which is frequently the case in public policy and other applied areas of WE).

CS/PS: the concept of surplus can be traced back up to A. Marshall and it tries to capture the utility gain that individuals obtain from acquiring (selling) the goods they want in the market at a lower (higher) price than that they were willing to pay (accept).

To obtain these surpluses all we need is the demand and supply curves and the market prices.

Using this device as a tool for analysing the welfare impacts of some economic change, all we have to do is to calculate these surpluses before and after the change and see what is the sign of its variation. If it is positive, we have a welfare gain, if it is negative, we have a welfare loss. Accordingly, the social welfare is maximized when the sum of consumer and producer surplus is maximized<sup>11</sup>.

CV/EV: These two concepts were first introduced by J. Hicks, Hicks (1940 and 1943), and can be defined as follows: in the face of a possible economic change we can calculate the amount that is necessary to transfer from or to the consumer in order to make him stay in the same level of utility as before the change – this is the CV; we can

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some conceptions of welfare that many might deem unfair or unreasonable. For that not to happen, an explicit assumption of cardinality is required. Also note that the same problem arises when analyzing some tools for applied WE (discussed later). On this see Sen (2000).

<sup>10</sup> Although, see Sen (1970), for surprising results on this issue.

<sup>11</sup> In the framework of neoclassical Economics (perfect rationality, perfect information and inexistence of public goods and externalities), that happens in the perfectly competitive market economy.



also calculate the amount that is necessary to transfer from or to the consumer in order to let him enjoy the new utility level (post-change) if the change does not occur – this is the EV.

CP: this device of analysis was first proposed by Kaldor (1939) and Hicks (1939). Their idea was to allow income transfers amongst individuals in a way that gainers from some economic changes could compensate the losers in a way that all agents gain with that change (potentially).

For Kaldor, if after some change there is some hypothetically appropriate income redistribution so that all individuals of society are better off, then that change is supported, even if the compensation is not actually carried.

Hicks has proposed a somewhat different approach. Using his criterion, the change is only desirable if there is no potential income redistribution in the pre-change state that can leave individuals as well as they become after the change. That is, a change is desirable only if doing the reverse change does not respect the Kaldor CP.

The most interesting point about these CPs is that they have deepened the focus of analysis towards efficiency issues<sup>12</sup>. Unlike the Pareto criterion these CPs don't demand an actual compensation. Hicks and Kaldor state their advices using only potential compensations. The step of actually compensating the losers is understood as a separated thing. If the change can respect the CP it should be supported, even if the compensation is never done. So, CP can support a change that violates the actual PC.

### *Theorems*

From the conjunction of some tools and principles described above and basic assumptions of neoclassical economics (to wit, perfect rationality, non-convexities in production and utility functions, competitive markets, perfect and symmetric information and non-existence of externalities and public goods) two theorems appear as benchmarks of the discipline of MWE.

They can be described as:

1<sup>st</sup> WT: any competitive market allocation is Pareto efficient. That is, if we have maximizers consumer and producers let alone in a perfectly competitive market

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<sup>12</sup> Nevertheless, see Sen (2000) to understand how that can be reinterpreted (CPs as not pure efficient measures as they imply some form of cardinality).

environment, the final allocation will be such that there is no possible trade among the agents that could improve the welfare of some without harm the welfare of others. In a word, all competitive market allocations are Pareto efficient;

2<sup>nd</sup> WT: under some reasonable hypothesis, all the Pareto efficient allocation can be attained through competitive markets given appropriate initial endowment redistribution (that is, all Pareto efficient allocations are competitive equilibriums for some endowment distribution) or any feasible and optimal resource allocation can be obtained via market mechanism, after some initial endowment redistribution.

With these theorems market allocations can be showed superior (in terms of efficiency) to other alternative resource allocations (as dictatorships, social plans, etc.)<sup>13</sup>. Nevertheless these theorems are silent when decision is needed between two different resource allocations (ex. one more evenly distributed than other) but both Pareto efficient<sup>14</sup>.

### *Social decision rules*

Within MWE, Social Welfare Function (SWF) is a device used to create a social decision rule over any set of relevant alternative social states.

It was first created by A. Bergson, Bergson (1938), and is since used with the intent of producing a complete social ordering over all the possible social states society might face.

The basis for a SWF is a Social Welfare Ordering (SWO) that can be represented by a function if it is continuous. This function aggregates the utility of individuals in a way that higher values of this function indicate a social preference for the social state to which that higher value is imputed (higher is better than lower).

MWE assumes that these SWF obey some basic characteristics that prompt their usefulness: welfarism (SWF depends only on the individuals utility valuations of social states), positive derivate<sup>15</sup> in each individual utility level (assumes the strong PC

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<sup>13</sup> Note however that this is different to say that the market mechanism is the only mechanism that should exist to perform resources production and distribution. The 2<sup>nd</sup> WT clearly opens space for State intervention in determining which final state is desirable by an initial endowments' redistribution operation. Only after that redistribution, markets will operate and bring the system to the desired and efficient final state.

<sup>14</sup> That's why tools such as SWF are needed to "close" the analysis of WE.

<sup>15</sup> Allowing for null derivate is necessary if one wants to include Rawlsian SWF. Nevertheless, that kind of SWF might be considered out of MWE.

criterion<sup>16</sup>) and convex to the origin indifference curves (assumption of diminishing marginal utility in utility gains).

With this theoretical device, the definition of the point (the social state) that maximizes the social welfare becomes possible: it will be the tangency point between the social welfare indifference curve and the utility possibilities frontier.

Given that, the main problem left will be the definition of a specific SWF.

According to the ideology and the preferences of each welfare economist, it is possible to create a particular SWF that reflects those options. So welfare economists are forced to define their assumptions on the type of Moral Philosophy that should be used to carry on the welfare analysis.

Using an utilitarian ordinal conception of SWF, the problem of finding a consistent way of ranking social states becomes a puzzle.

By the Arrow's Impossibility Theorem, Arrow (1951), we know that there is no SWF that can fulfil some very basic desirable properties (namely, unrestricted domain, PC, non-dictatorship and independence of irrelevant alternatives). That is, in this ordinal utilitarian framework, we cannot get a consistent ranking of social states (even if we use some democratic rule as majority voting), unless we use some individual ordering as the society's representative ordering. But that would not be correct because it would correspond to a social dictatorship<sup>17</sup>.

On the other hand, if we allow SWF to be cardinal and fully measurable (which implies some form of interpersonal comparison of utilities) we will face the reverse problem: there will be a large number of possible SWF that we can construct based on individuals utilities. It will be then crucial to specify the ethical assumption we want to use in order to be able to choose from that wide range of possible SWF.

Simplifying the problem, we can say that there are two main different kinds of ethical assumption usually made.

One (and the most popular) is Utilitarianism. According to this view the welfare of the society is given by the sum of the welfare of individuals. If we assume that individuals' welfare have the same weight, then, we are dealing with the Benthamian Utilitarianism and we will have negatively slopped straight lines as social welfare

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<sup>16</sup> The notion that state A is only preferred to state B if in B at least one person is better off than in A and no one is worse off.

<sup>17</sup> The hypothesis of an elected benevolent dictator could diminish the undesirability of such social dictatorship but is, nevertheless, of very little practical interest (due to the implausibility of a benevolent dictator due to incentive problems).

indifference curves<sup>18</sup>. Instead, if we weigh individuals' welfare differently (weighting more the ones with less utility) we will obtain strictly convex social welfare indifference curves. In this case, social welfare can be improved by a redistribution of income from those who have higher utility to those with less utility<sup>19</sup>.

The other, is Rawlsianism. Inspired in the concepts of justice postulated by J. Rawls in his Theory of Justice (1971), some welfare economists think that the appropriated SWF must be design in such a way that we can only improve social welfare by increasing the welfare of the poorest guys on the economy. This implies Leontieff type social welfare indifference curves. With that, one can advocate an increase in income inequality only if that contributes to the improvement of the poorest guys' welfare.

It is interesting to note that if we assume diminishing marginal utility of income and equal utility functions across individuals, Benthamian SWF declare the egalitarian income distribution as the one which maximizes social welfare. Although it is indifferent between the *utilities* of individuals, the way to maximize the sum of their utilities is to put forward the egalitarian *income* distribution. In this context, economic changes that prompt income equality are advisable.

Nevertheless, it is still possible to assume that individuals have different utility functions (more realistic). If that's the case, the income distribution that will leave all individuals with the same marginal utility of income (Pareto efficiency condition) will not be the egalitarian distribution.

We can summarize all that has been said about SWF by stating that if we stick to the utilitarian ordinal view of utility, SWF will be impossible<sup>20</sup>. On the other hand, if we allow for measurability and comparability of utilities amongst individuals, we are forced to make ethical assumptions about what social welfare is. If that is our choice, we can use SWF to rank different social states but those rankings will always be moral values dependent and so, in some way, subjective.

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<sup>18</sup> A social indifference curve is a mapping of points that return the same level of social utility for each level of individual utilities.

<sup>19</sup> Here, a distinction between the impacts of the sign of the marginal utility of income (or other goods) and the assumption about the aggregation of individuals' welfare is important to make. The first will determine the shape of the utility possibilities frontier (straight line if zero, concave if negative, convex if positive) while the second will determine the shape of the SWF indifference curves (with  $SW = \sum \alpha_i U_i$ , straight lines if  $\alpha_i = 0$ , convex lines if  $\alpha_i$  bigger for smaller  $U_i$ ). With  $\alpha_i$  bigger for smaller  $U_i$  we will have higher SW with more equal distribution of income for both negative and null marginal utility of income. Also remind that under diminishing marginal utilities of income, the Benthamian SWF will also be maximized with an egalitarian income distribution.

<sup>20</sup> Although see Fleurbaey and Mongin (2005), Little (1952), Bergson (1954), Samuelson (1977).

### *Tools for applied WE*

As the name indicates, applied WE is the branch of WE that uses its theoretical apparatus to proceed with analysis of actual and practical policy issues (like deciding the amount of a tax, the construction of a new road or bridge, etc.).

It is by using the tools of applied WE that economist can advise policy makers in conducting their policies.

Not surprisingly, problems of public goods are the ones decision-makers most usually deal with. Consequently, most tools developed by applied WE intent to assess the welfare consequences of decisions over public goods<sup>21</sup>.

A brief description of what CBA and other practical approaches to applied WE (namely to public goods) are, follows.

The CBA is a widely used instrument to assess the social welfare consequences of medium and small public projects<sup>22</sup>. It tries to inform the actual social benefits and social costs of the implementation of some public project.

When a government decide to implement some public project it must be aware of the welfare consequences that project will have on society. It has to analyse the impacts of that project on the consumer social welfare (the aggregate consumers' willingness to pay for the changes that will occur) on the social cost (namely the consumers' valuation of the production losses due to the move of some inputs from private to the public project) and the own governmental gains with that project (and the effect different gains' distribution amongst households have).

The CBA tries to build some practical rules that allow governments to capture these main areas of impact of any public project, trying to ensure an accurate measure of its welfare consequences on society.

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<sup>21</sup> Remember that whenever a well established market for some good exists, welfare economists think that the most accurate and efficient form of collecting information about the welfare of agents and their willingness to pay or accept for some economic change is the observations of their market behaviour, their choices and the actual market prices. It is understood that the market prices and agents' behaviour reveal their preferences and so we can assess their welfare changes through the variations on those variables. Nevertheless, applied WE frequently wants to analyse economic changes that occur within contexts where markets are incipient or fail to exist. That is the case of many public goods where we know markets fail to be efficient. In such situations, we cannot rely on market information (agents' market behaviour and market prices) to build our welfare analysis.

<sup>22</sup> In theory, this tool should be used to assess all the social welfare consequences of all kinds of public projects, no matter how big they were and how large its influence over all the economy. In practice, that is never done due to its huge degree of complexity and consequent inefficiency.

The other most used practical methods are: Survey data, Clark-Groves Mechanism, Travel costs and Hedonic Prices.

The *Survey method* is simply the usage of survey information to grasp the agents' willingness to pay or to accept for some economic change.

In a very direct way, agents are asked how much are they in the disposition to pay for some change to take place (CV) or how much do they require being paid (how much they accept) for some change not to happen (EV).

The *Clark-Groves mechanism* is a device devised by Clark (1971) and Groves (1973) that induces individuals to reveal their actual preferences over a public good.

This scheme is though to be incentive compatible and works the following way: for a project to be approved, we impose a share of its cost to all individuals. Then we ask their willingness to pay and say to them that the project will only be undertaken if the total willingness to pay exceeds the total cost. Finally it is imposed that every pivotal individual (i.e., every individual that might change the decision of implementing or not the project according to his willingness to pay) pay a tax (equal to the absolute value of the sum of each of the remaining individuals' willingness to pay less their total cost share of supplying the good).

With this we can actually obtain the true welfare values of the economic change but we impose a non Pareto efficient allocation: the collected tax must disappear from the economy (in order for agents not to behave strategically and corrupt this scheme) so we face a resource waste. Besides, some agents will lose and others gain with the changes supported by this scheme.

The *Travel Costs*<sup>23</sup> method uses the idea that even for a free of charge service or public good, agents who actually use it face, nevertheless, some costs. One of them is the travel costs. For instance, an agent wanting to go to a public park has to actually go there. In doing so, he/she faces travel costs.

So, in trying to evaluate some public good of this kind we can add the travel costs agents support in order to utilize it and calculate an approximated welfare value of that good (again using the idea of surplus). It is worth noting that for many types of public goods (like National Defence) this method is not applicable.

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<sup>23</sup> See Timmins and Murdock (2007), Shrestha et al. (2002), Hailu (2005), Clarke (1998) for contemporary applications.

The last method we will talk about is *Hedonic Prices*<sup>24</sup>.

The idea behind this method is to try to capture the value of some public goods through the prices of some private goods (for instance, houses). Using econometric techniques it is possible to isolate the contribution of the different characteristics of some goods to its price. If some of those characteristics are a public good (as air pollution) we can assess the value of that public good by finding the difference between the prices of two (other than the public good characteristic equal) private goods.

Again this method is not perfect and is has a limited scope of application within the framework of public goods.

From all discussed above some conclusion might be retained: MWE is a vast discipline, encompassing the utilization of different applied techniques and relatively different theoretical models; shows a good level of coherence between the tools for applied WE and the theoretical analysis based on ordinal utility<sup>25</sup> (coherent with mainstream economics assumptions); PC is structural to MWE making it biased towards efficiency issues, away from equity ones<sup>26</sup>; MWE determine the supremacy of market outcomes (market efficiency in terms of Pareto), that is, the best social welfare can be achieved through free markets, free agents interaction<sup>27</sup>; SWF is the most controversial part of MWE because ordinal utility paradigm doesn't fit (due to AIT) and there is no consensus over the alternatives (that's why it is also disregarded in most applied works<sup>28</sup>).

In conclusion we can state that there is a core of crystallized techniques which characterize MWE but there are still some disputes and unsolved issues within it.

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<sup>24</sup> See Sengupta and Osgood (2003), Wang (2003), Dickie et al. (1997), Arimah (1992), Tse (2002), Hamilton (2007), Pope (2007) for contemporary applications.

<sup>25</sup> Never forgetting the difficulties that might arrive once we start to deepen the methodological analysis and find that there is a tension between the rhetoric of economists (advocating ordinalism) and the reality of theirs practices (like using additive SWF which imply cardinality).

<sup>26</sup> Nevertheless, remind that PC is of very little use when it comes to practical issues (someone is always worsened as a consequence of policy implementation).

<sup>27</sup> Even when markets face some difficulties (like externalities, natural monopoly or asymmetry of information) the best way to overcome those problems (so that the market interaction recover its "natural" efficiency) is through interventions on agent's incentives scheme, not through state planning. Nevertheless, this does not imply the abolishment of the State. The State might still have a role in determining the social optimum.

<sup>28</sup> See, for instance, Just (2004). Nevertheless SWF is a central issue for social choice theorists (most of them explicitly assuming cardinal SWF). Many economists also use SWF as arguments of maximization problems (even though no explicit reasoning is made about which conception of utility is being used).

Furthermore, those disputes are more visible at the theoretical level (choosing between different SWF<sup>29</sup> and discerning the role of cardinality and ordinality) than at the applied one (where CP is the dominant force).

Nevertheless, many applied and theoretical welfare economists are aware of those difficulties and find MWE too narrow to encompass the actual problems of social welfare<sup>30</sup>.

It is mostly amongst economists who are more interested on the welfare issues of societies like unemployment, poverty, equality of opportunities, freedom, growth, etc.<sup>31</sup>, that we can easily find support for alternative theories of welfare, precisely because it is on those very issues that the MWE techniques show up their major weakness and flaws<sup>32</sup>.

That's why, wanting to enrich the scope and power of WE, many economists criticize WE state of the art and propose alternatives. From a myriad of authors and alternatives, we think two deserve our special attention: Sen's capabilities (SC) and the Happiness literature (HL) approaches<sup>33</sup>.

For Sen (see next section for details) MWE is quite limited mostly because it uses a very limited source of information when conducting welfare analysis: utility derived from observed choice behaviour. Instead, information about capabilities (the actual possibilities humans have to lead the life they want/have reason to value) should be the answer.

For the HL (see section 4 for details) the main problem with MWE lies on the incapacity of it to accept cardinal and subjective assessments of utility and to admit that not all is revealed through choice behaviour (for instance, when people fail to predict the interpersonal and intrapersonal comparisons effects, that is, when there is imperfect rationality).

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<sup>29</sup> It is worth noticing that it's in the context of SWF discussions that most criticism to MWE appears. For the critics, MWE cannot neglect SWF just because it doesn't fit the revealed preferences/ordinalism framework. Quite the opposite, that incapacity of ordinalism to define a reasonable SWF is a definite reason why the ordinalist paradigm should be abandoned, even because not defining explicitly the ethical background of hidden behind ordinalism doesn't eliminate the fact that some choices have been made implicitly.

<sup>30</sup> Knowing the practical nature of MWE, heterodox welfare economists urge to build new and reliable alternatives: if MWE were to be wrong, so would be the policy advices (and consequently the actual policies, whenever economists are consulted as advisers).

<sup>31</sup> These are core issues of branches of economics like Labour, Growth or Development.

<sup>32</sup> When facing real life facts, those economists realize the huge discrepancy between the expected welfare consequences of MWE policies and their actual consequences on the populations.

<sup>33</sup> Sen is a long time development economist and one very preoccupied with poverty. Within the HL, Richard Layard and Andrew Oswald are long time Labour economists. This goes well with our previous statement.



Another possible weakness of MWE is the already cited reliance on methodological individualism and individual rationality principle: criticism might focus on the need to escape the “homo economicus” paradigm reverting to more empirical version of economic agents (with reasoning influenced by emotions, habits, myopia, and a more realistic conception of welfare as a psychological phenomenon, etc.) and to more relational notions of welfare (escaping the individualistic paradigm where all kinds of welfare can be reduced to and individual experience<sup>34</sup>). The methodological individualism is, by itself, a long and complex line of criticism to MWE, but one that we will not be paying special attention here, unless related to SC or HL main criticisms. On the other hand, the reliance on the perfect rationality principle is a major criticism both SC and HL direct against MWE. We will then study it more carefully.

### **3. The Capabilities Critique**

Wanting to understand the role HL might have on WE, it is very important to examine what SC approach is and what is its place on WE. There will only be room for HL in WE if it adds something to MWE that SC haven’t already been able to put forward<sup>35</sup>.

SC approach is, nowadays, a well established and recognized form of dealing with welfare problems within Economics<sup>36</sup> (not only within WE but also on Development Economics).

As the name indicates, Amartya Sen is the founder and the main developer of such theory<sup>37</sup>. Sen was not content with the answers MWE gave: for him, there was a vast list of important issues orthodoxy could not deal with. So he proposed other methods should be used instead. Mostly, that capability set should be the informational base welfare economists ought to use when performing their analysis (their welfare assessments).

For Sen, MWE basically relies on the idea of utilitarianism (and in a specially restrict one), one that accepts only ordinal utility inferred from choice behaviour as a reliable source of information for welfare analysis (restricted welfarism). Even

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<sup>34</sup> See Zamagni (2002) for a detailed analysis on this subject.

<sup>35</sup> On the similarities and differences between SC and HL see Comim (2005).

<sup>36</sup> This can be witnessed by the penetration this approach have on both economic journals and international institutions (like the World Bank and United Nations).

<sup>37</sup> A detailed analysis of what this theory is and how it can be applied might be found on Sen (1999).

considering the most powerful version of utilitarianism (like the cardinal one), Sen argues for its demerits: the persistency of some extension of the AIT and incompatibilities between Pareto criterion and liberal values (which imply that not even the most used and supposedly uncontroversial welfare criterion of MWE is useless once one imposes private spheres of freedom<sup>38</sup>) are just two examples of the weaknesses utilitarianism suffers from Sen's viewpoint<sup>39</sup>.

Given that, Sen believes, it becomes crucial to utilize extra-utility information in order to produce more solid welfare analysis<sup>40</sup>. Using extra-utility information (as capabilities deprivations, for instance) Sen believes one can escape the impossibility results and analyse distributional issues of welfare (equity problems).

Sen is very concerned with the subjective nature of utility (even when revealed from its "objective" facet of choice behaviour) because he finds agents too prone to adaptation<sup>41</sup> in order to utility to stand as a good welfare criterion (not mention as the only one).

He points out the capability set as the true objective information welfare analysts should look at. There, one could assess objectively where agents stood in welfare: are they undernourished, are they ill, under-educated, relatively poor, apart from social life, do they have a chance to live for long, do they have access to health care, do they have a chance to actively participate in social life and flourish, etc.? All these questions can be answered objectively without the need of utility assessments<sup>42</sup> (that is, independently of what people think about it or feel).

For Sen, the possibility of feeling well (having high levels of subjective well-being and reported happiness) is just one capability that should be taken into account. Yet, there are also different capabilities as valuable that cannot be reduced to its consequences on psychological well-being: life-expectancy at birth, equality of

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<sup>38</sup> See Sen (1979a, 1979b).

<sup>39</sup> See Sen (1983) for a closer analysis.

<sup>40</sup> And to reconcile welfare analysis with some notions of justice and values such as Freedom: on Unitarian grounds, Sen claims, all sorts of barbarities (like slavery, hunger, genocide, etc.) can be theoretically justified.

<sup>41</sup> Sen is very concerned with the possibility of one person to accommodate (because that person was raised that way, has an acquiescent personality, etc.) to a very bad and degrading situation (in India, when asked about their own condition, some individuals of the poorest and degraded casts, stated that they were not that bad, some times even saying they were ok, Sen (1999)). Note that this very process of adaptation also undermines perfect rationality. So, not only the concept of utility is poor, the individual MWE uses on its models (perfectly rational agent) is unrealistic. As a result, MWE conclusions and policy advices can be misleading.

<sup>42</sup> One can construct indexes of deprivation or satiation on all the referred items, obtaining a number that states the welfare situation of individuals and groups.

opportunities amongst gender, race and social class, political and economic freedoms, etc., are just few examples of capabilities Sen deems crucial for every human society and that cannot be reduced (or be judged their importance) to its impact on Happiness.

Furthermore, Sen is also worried with the procedural facet of welfare: not only the consequences, the results, are valuable but also the number of options (possible results) and the very process by which one obtain certain result matter<sup>43</sup>.

For example, having a dictator implementing a presumably good set of policies or having the same policies put forward by a democratically elected government can imply the same results but the process is different. The capability of freedom to choose the government is available in the second case, not in the former<sup>44</sup>.

Introducing SC one can enlarge the power of analysis of WE and rank situations one could not rank before (when only using MWE techniques). One can judge processes, relational problems, absolute and relative deprivations, etc. Yet one faces a new problem: if neither agent's behaviour nor their subjective assessments are crucial to welfare judgements, what is the criterion to define welfare?

Sen uses a vague expression to define capabilities (his chosen informational base to produce welfare judgements): capabilities are everything humans value or have reasons to value. After, evokes a list of things that, in fact, people normally tend to value (like health, income, subjective well-being, freedom, etc.). Nevertheless, he gives us no definite criterion to classify something as a capability or not. With that opens the way to discussion, confusion, ambiguity and, interestingly enough, subjectivity (each can determine what is or is not capability<sup>45</sup>). At the end of the day, the so wanted objectivity remains unattainable<sup>46</sup>.

On this respect it is worth noting that SC cannot be fully understood without a reference to the Rawlsian Theory of Justice as Fairness expressed on Rawls' "A Theory of Justice" (1971).

The ideas there developed by Rawls, namely his concept of primary goods, can be regarded as the inspiration for Sen's Capabilities.

Rawls was concerned with the definition of basic principles that should govern the foundations of the basic structure of a fair society. He defined that there were two

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<sup>43</sup> This departure from a pure consequentialist framework contrasts with MWE (and with Utilitarianism).

<sup>44</sup> Note that using the mainstream utilitarianism, consequentialist as it is, the two setups could not be distinguished in terms of welfare. Using SCA, they can.

<sup>45</sup> One mild restriction Sen imposes is the necessity of an ideally long period of open, public and democratic discussion so the concept of capability might emerge Sen (1999).

<sup>46</sup> Later on this paper (section 5) we will return to this issue more carefully.

principles of justice<sup>47</sup> that served that purpose and that those principles would be chosen by reasonable human beings put in an ideally original position under the *veil of ignorance*. The society then constructed, would be *well-ordered*.

Throughout the process of choosing those principles Rawls declared primary goods as the informational base for welfare judgments.

Primary goods, he defined, are all things that a rational human being supposedly desire and that are normally valuable independently of the course one wants to give to ones life. Examples of primary goods are: rights, liberties, opportunities, income, wealth and the basis for self-respect<sup>48</sup>. It is with respect to the individuals' possessions of these goods that welfare statements should be made (and also when deciding about the fairness of some principle or situation, the impact over the expectations individuals' have about their claims of primary goods is the appropriate space of judgment). This notion is very close to the one of capabilities and can be interpreted as Sen's inspiration for his work on WE.

Interesting enough, Rawls has served as inspiration also for some mainstream welfare economists who tried to incorporate his ideas within the welfarist framework (with the max-min principle and the Leontieff type social indifference curves already mentioned in section 2). Nevertheless, that incorporation has to be seen as misleading: Rawls clearly departs from both welfarism and utilitarianism (cornerstones of MWE that Sen also rejects). He builds his theory under the *social contract theory* line of work (where Locke, Rousseau and Kant are prominent authors, all disagreeing with utilitarianism) and defines primary goods as the informational base one should look at when evaluating the welfare of individuals, not utility (thus rejecting welfarism). So, Rawls is clearly closer to Sen (or Sen is closer to Rawls) and his work has opened the way to the capabilities approach to WE.

One last remark serves the purpose of noticing one difference between Rawls' and Sen's ideas. As a welfare economist very concerned with poverty and underdevelopment issues Sen have a strong practical inclination which is reflected in his conception of capabilities where the *actual* word was essential: capabilities are the

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<sup>47</sup> Those principles are: first - every people should have equal wrights to the most enlarged possible complete system of basic liberties compatible with an identical system of liberties for all; second – social and economic inequalities should be distributed such as, simultaneously: a) the less advantaged get the larger possible benefits compatible with the principle of fair savings; b) those inequalities are the consequence of being in charge of certain positions and functions open to all in conditions of equally fair opportunities.

<sup>48</sup> These are examples of social primary goods. Health, intelligence and imagination can also be counted as primary goods, but as natural ones.

*actual* possibilities an individual possesses to lead the life he/she wants. Formal, constitutional possibilities are not enough to be counted as capabilities. Au contraire, Rawls (as a Philosopher) was more concerned with the design of a fair society and gave primary goods a more formal/constitutional flavour, stressing the importance of constitutional fair rules that generate fair expectations about primary goods, and not so much actual fair opportunities in accessing those primary goods (as he was dealing with the construction of the basic structure of a society, not with any particular real society).

#### **4. Is There Room for Happiness?: (re)introducing subjective approaches into Welfare Economics**

Happiness is a vast concept: one of the main concerns of philosophers and one of great dispute about its content. It is also one of the most important things for humans (for some, the definite goal of human existence).

One could think that Economics, as social science studying the society and the individual, would give a relevant place to happiness, at least on their welfare analysis. In fact, that's not the case (or at least, that is not a straight story).

MWE, as already noticed, uses a very abstract notion of utility, one that clearly has few to none connections with Happiness. In MWE utility is empty of psychological meaning (in a sense is just a theoretical artefact) as it is assumed that all one needs is the observation of choice behaviour (and the consequent revealed preferences).

Nevertheless, that has not always been the case in Economics<sup>49</sup> and recent research on subjective indicators of welfare has put Happiness back on the track of many economists' research agenda.

In particular, data on Subjective Well-Being (SWB) gave rise to some interesting and puzzling findings to the economic profession: Easterlin's Paradox<sup>50</sup>, Easterlin (1974), is probably the most widely used finding to demonstrate that something is wrong with MWE.

MWE seems to look at income growth as one objective way of increasing welfare: if mean income rises and, admittedly, no one's fall, then welfare ought to rise

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<sup>49</sup> See Bruni (2004a, 2004b)

<sup>50</sup> The finding that, although within a country the richer are happier than the poorer, throughout time (for the same country), and despite huge increases on per capita income, the mean happiness remains almost the same (at least in the richest countries).

(as the Pareto criterion would corroborate). Easterlin's Paradox clearly shows that that has not to be the case and that the reason why MWE fails to see it lays on the utility conception and rationality assumption it uses.

For HL, there are new stylized facts that are incompatible with MWE assumptions.

For HL, agents are myopic, systematically myopic. For instance, agents fail to perceive that consumption<sup>51</sup> only produce happiness if our consumption is bigger than our reference group's average (comparison effect), bigger than what has been in the past (adaptation effect), and close to our expectations. As a consequence agents over invest in consumption (and for that in work) gaining less happiness than what they have thought.

Furthermore, subjective assessments of welfare are counted as reliable, comparable and scientifically rigorous<sup>52</sup>. Utility is understood as a psychological reality that might have some cardinal nature (comparable interpersonally and cross-country) and that can be grasped, namely through questionnaires.

In fact, within the framework of HL, Easterlin's Paradox vanishes at the same time as new areas of analysis become tractable by WE.

HL can be understood as a return to the early days of neoclassicism, and to the ideas of J. Bentham (who conceived agents as pleasures seekers and pain evaders) of cardinal and measurable utility<sup>53</sup>. Nevertheless, HL uses new findings and techniques (from economics but also from psychology, neuroscience and sociology) empowering its analysis such that old criticisms early neoclassicism faced are overcome<sup>54</sup>.

HL challenges MWE in several ways: not only with respect to the techniques employed but also on the basic assumptions about rationality and utility. As already said, HL disputes perfect rationality, revealed ordinal utility, classical preference axioms, surplus analysis, the role of GDP in orthodox welfare policy, etc., but offers comparison and adaptation effects analysis (hedonic treadmill), SWB and survey data. Nevertheless, many authors on the HL still retain the utilitarian and individualistic

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<sup>51</sup> Mainly conspicuous consumption, see Frank (2005).

<sup>52</sup> See Veenhoven (2002) to a detailed analysis why subjective measures are important in welfare assessments.

<sup>53</sup> Although not necessarily endorsing the Benthamian moral theory (which states that good is everything that prompts human pleasure and bad all that dooms it).

<sup>54</sup> More and more evidence, see Layard (2005), from psychology and neurology show that the sensation of well-being can be assessed (via brain scans and electroencephalographs) and that it has a physical and chemical nature. That strengthens the idea that utility is something real and objective (also strengthening the hypotheses that it can be grasped objectively via questionnaires).

paradigms<sup>55</sup>. And that is what turns HL apart from SC as this last is clearly non-utilitarian and anti methodological individualism. In a way, HL could be understood as a middle point between MWE and SC (or the closest version of utilitarianism to SC approach): both HL and SC reject restrict utilitarianism, ordinalism, perfect rationality, and choice behaviour paradigm (fundamentals of MWE) but where SC demands for capabilities (non-utility information, a radical cut with utilitarianism) as alternative, HL stands for Happiness (new interpretation and measures of utility, new versions of utilitarianism). The supporters of SC deem happiness as just one capability amongst others of equal or higher importance (as freedom) while HL deems capabilities as explanatory variables on happiness equations (well-nourished, free and rich persons will be happier).

So, HL is not equivalent to MWE as uses types of information and methods that were rejected by the last (although sharing utilitarian philosophy) and is not equivalent to SC approach as accepts utilitarianism while SC approach propose capabilities (although sharing some techniques, data and policy conclusions). More, HL might be closer to SC from an applied/political point of view, but from a philosophical point of view HL is closer to MWE<sup>56</sup>. At the end of the day, there is justification for HL to stand out as an alternative approach on WE, to both MWE and SC<sup>57</sup>.

Nevertheless, HL is still a recent line of work and continues to deal with some internal incoherencies and disputes. Even so, it's gaining notoriety (both in scientific forums and the media) and it's growing in credibility attracting more and more economists to its milieu, something that can be witnessed by the increased number of papers published on this issue and in top rated journals<sup>58</sup>.

At the end of the day HL proves it cannot be neglected when proceeding with an economic analysis of welfare.

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<sup>55</sup> Of course some reject utilitarianism (most of those being closer to SC approach than to HL) and others the methodological individualism, see Zamagni (2005), Sugden (2005) and Bruni (2006), claiming the need for relational views on Economics if happiness is to be properly incorporated.

<sup>56</sup> Which proximity is more important might be a subject of discussion. Nevertheless, from a fundamental point of view, the break between utilitarian (MWE and HL) and non-utilitarian (SC) analysis appears as the most relevant.

<sup>57</sup> Even if there is the temptation of MWE to incorporate HL main findings and assumptions (as HL remains utilitarian and as the imperialism of economics would predict) that is not a problem to HL's relevance: quite the contrary, that would mean that MWE have recognized validity and robustness in this new line of work.

<sup>58</sup> Tella, MacCulloch and Oswald (2001) on the American Economic Review, Clark and Oswald (1994) on the Economic Journal, and Blanchflower and Oswald (2004) on the Journal of Public Economics are just few examples.

## 5. Happiness, Capabilities and Orthodoxy: the same policy conclusions?

After all that have been said in the previous sections some fundamental questions remain to answer (or to be clarified): do these theoretical and conceptual disputes have practical consequences? Does the chosen theoretical framework give rise to different policy advices?

The answer is yes, and for three main reasons: first, different conceptual frameworks allow economist to analyse different problems; second, even for the same problems, the different theoretical setups may imply different policy conclusions; third, even if for the same problems different theories imply similar policies the justification for such policies will be different, grounded on different concepts and values<sup>59</sup>.

Over the previous sections we have analysed the main characteristics of three approaches to WE: SC, HL and the MWE. There we have noticed that each has its specific set of assumptions and tools. Now we try to clarify which policy consequences each brings about.

MWE, SC and HL differ in many ways: theoretical, philosophical and methodologically. It is then not surprising that each approach advocate different kinds of policies for welfare enhancement (both individual and societal).

Using the methodological individualism, consequentialism and behaviourism (the revealed preference and ordinal utility framework), most MWE models end up with liberal policy advices: free individual interaction through markets is the best way for society to reach welfare (once the basic rules of law and justice are guaranteed). The welfare analyst can support market liberalization policies since those same policies generally promote Pareto movements (in the Kaldor-Hicks sense). Beside that he/she has very little space of action: cannot judge over non-Pareto movements, can not judge distributional issues of welfare (if both states A and B are efficient from Pareto's viewpoint, but A is extremely unequal whereas B is equal, A and B have to be classified as equal using MWE) and (extremely important<sup>60</sup>) can not judge welfare variations not grasped through observed behaviour (for instance, can not qualify between different

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<sup>59</sup> Important as this “justification”/philosophical issue might be, the relevance of new approaches in WE springs mostly from the different policy conclusions and enlarged domain of analysis (the first and second reasons).

<sup>60</sup> Since agents might not be (are not) perfectly rational, not always doing the best moves.



situation in terms of actual range of choices, processes and freedoms). All these are lacunas that can be overcome with a paradigm change<sup>61</sup>.

That's exactly what SC and HL try to do, even if using different strategies.

SC marks a clear turn in most assumption and structures of welfare analysis: it departs from consequentialism (as it puts great emphasis on the processes through which every final state might be achieved, ranking those states accordingly), from ordinal utility (as it deems all forms of utilitarianism as poor in terms of the used informational base<sup>62</sup>), from hedonism (advocating a more eudemonistic conception of welfare where happiness can only emerge through human flourishing and relinquishing happiness as the ultimate goal of human existence), from methodological individualism (as it considers that many welfare phenomenon can only be understood when using a relational approach<sup>63</sup>) and from perfect rationality (agents are conceived as complex psychological entities). With all this it is not surprising its welfare analysis differ from those of MWE (the same goes for the policy conclusions).

For Sen, the core of welfare lies on the actual possibilities individuals have to lead the life they want or have reasons to value. For that, issues like access to food, healthcare, education, political activity, income, work and protection from abuse, tyranny and discrimination (sexual, religious, racial, etc.) figure high on the list of welfare essentials.

In terms of policy, it becomes easy to understand that the promotion of healthcare, education, democracy, markets and the rule of law are top priorities.

Using SC it is crucial to grasp the situation societies are facing in respect to capabilities and attack (using the proper policy schemes) the weakened areas. If the policy maker finds out that in society A people are getting richer and richer but there is no democracy then there is plenty of room for policy intervention in order to promote democracy, so augmenting welfare (capabilities)<sup>64</sup>.

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<sup>61</sup> Of course some of these difficulties could be over passed if a cardinal SWF was chosen. Nevertheless, as noted in section 2, that is not usually done by mainstream welfare economists.

<sup>62</sup> Capability set being the alternative informational base to be used.

<sup>63</sup> Considering that some aspects of human welfare are intrinsically relational (for instance, the welfare of a friendship, if conceived as the very relation with a friend, cannot be reduced to the SWB it generates on the individuals).

<sup>64</sup> Note that if one have used MWE it would be very hard to support any kind of intervention: agents were acting in a way that income was raising so that, probably, we were facing a Pareto movement. Also actions were silent in respect to the lack of democracy. Nevertheless, they could prefer democracy. So, if agents are only allowed to "speak" through their actions, a lot can be left to be "heard".

SC is a framework of analysis used more and more to ground and conduct welfare analysis and policy<sup>65</sup> and marks a clear depart from MWE ideals.

HL is a recent track of research not yet as established as both MWE and SC. Because of that it is still facing some problems of dispersion (different kind of methods, models and techniques employed, different results and policy conclusions<sup>66</sup>). Nevertheless it is now possible to identify a core of assumptions, ideas and main conclusion (also in respect to policy) that almost all researchers agree with. Within that core we can put forward the *comparison effect*, the *adaptation effect*, the *expectation effect*, the *diminishing marginal utility of money*, the difference between *decision and experienced utility*, Kahneman (1997), and the importance of the different impact each *life domain* has on happiness<sup>67</sup>.

All these facts have strong policy implications in directions that clearly diverge from those of MWE.

Once we accept agents compare what they now have with what they had in the past and adapt (more or less quickly) to the new standard, compare with what others (from one's reference group) have, compare with one's expectations of what one should have (this expectations again depending on society and group culture, norms and values), and do all this differently for each life domain (like work, family, leisure, income, etc.), we are forced to deem MWE as unreliable and mistaken. After all, in this context, agents are not perfectly rational (they incur in repeated mistakes and show signs of addictive behaviour<sup>68</sup>), information doesn't flow fluently, and markets become imperfect.

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<sup>65</sup> The United Nations' Human Development Index (HDI) was created embodied with SC approach ideas: the introduction of life expectancy at birth and literacy in combination with GDP per capita in a development index is a concession to the idea that not all can be translated into money (each capability is autonomous and cannot be transformed/translated into another).

<sup>66</sup> Some (mostly economists and sociologists) prefer to use subjective notions of happiness (with underlying utilitarianism, hedonism and methodological individualism), adopt an empirical route and believe life events (demographic, economic, social, etc.) can have a large and permanent impact over happiness (see Blanchflower and Oswald (2004a, 2004b), Clark and Oswald (1994), Frey and Stutzer (2002), etc) while others prefer to rely on objective happiness, Kahneman (2000), proceed with theoretical analysis, use relational approaches, adopt procedural views and support eudemonism (see Zamagni (2005), Bruni (2006)), or even support (mostly psychologists) the set point theory (where SWB appears as stable over time for every individual, like a personality trait that can only temporarily be affect by life events (see Diener and Diener (1996))).

<sup>67</sup> Each life domain contributes with a share to our feeling of happiness. One cannot be happy with the fulfilment of just one life domain. Furthermore, the prevalence and strength of comparison, adaptation and expectation effects (that are crucial to the sensation of happiness) differ across life domains. For instance, the financial side of life is much more prone to adaptation than the family side.

<sup>68</sup> The same is to say that their behaviour is contrary to what it should be in terms of welfare maximization. So, using that behaviour to reveal utility becomes a wrong theoretical choice.

One stylized fact of HL is the diminishing marginal utility of GDP per capita: after a certain level, continuous increases on GDP can't push happiness levels any further. That is, despite agents (through markets and governments) moving (behaving) in line with increasing income, that turns out unproductive in terms of welfare augmentation. The so called Pareto movements are, after all (if we take SWB as a good measure of welfare), not efficient in terms of welfare (they are Pareto efficient in income, not in welfare).

If what WE tries to analyse (and promote) is real welfare then HL shows that it has to do much more than stick to agent's behaviour, to income and monetary evaluations.

If markets were perfect (as is usually assumed in MWE), there were no externalities and information was perfectly available, MWE main postulates (like the first and second welfare theorems) would be correct and little would be left to discuss: market clearance would bring about the maximum possible societal welfare. With that, policy advice would have to be in the direction of market promotion (even if after an initial endowment redistribution done by the State).

Yet, if some (or all) of the above conditions fail to be present not only the welfare analysis will be wrong, also the policy advice.

We have seen that both SC and HL criticize the purity of markets and agents and consequently the validity of MWE. They try to build new evidence, tools and theories. In the end, advocate different policies for welfare.

In what's left in this section we will focus our attention in two major areas of human welfare and understand how our previously studied approaches deal with them: freedom and income.

Freedom and income are basic goods<sup>69</sup> generally conceived as crucial to human welfare. In WE that's also the case (although more the case for income than for freedom).

Income is the most studied within economics (and consequently on MWE) and is normally conceived as a benchmark of economic well-being and as an objective scale through which most types of welfare can be analyzed<sup>70</sup>.

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<sup>69</sup> Or Primary Goods as in Rawls (1971).

<sup>70</sup> This is a consequence of the admitted objectivity of income in comparison with other proxies of welfare and the conviction that most relevant economic welfare issues can be translated into monetary figures. Nevertheless, economists have long realized that these income measures of welfare suffer from several difficulties (see, for instance, Samuelson (1974)).

Freedom is a more controversial issue since it is a vaguer concept. It can assume a political nature (democracy versus dictatorship), an economic nature (free entrepreneurship versus planned economy), a societal nature (closed versus open societies), and individual nature (individuals with private spheres of freedom versus totally controlled individuals), etc. In WE freedom is usually analyzed as economic freedom (also as freedom of choice over consumption goods) and is integrated into policy advices by the idea that more freedom lead to enhanced market efficiency.

Let's analyze both issues more carefully.

### **5.1. Freedom**

As previously said freedom is a vast concept, prone to confusion and disagreement about. Nevertheless it is normally regarded as very important for human welfare.

Within MWE analysis freedom usually enters as freedom of choice over options: more choices means greater opportunity for maximization (in a constrained maximization framework, relaxation of constraints normally means higher level of maximum utility) and hence, higher levels of welfare<sup>71</sup>. Yet, more fundamentally, freedom is only conceived as a precondition for maximization: agents must be free to maximize their utility. Freedom also means freedom to participate in markets, buying, selling and producing goods.

For Sen (and also for supporters of SC) this is a clearly poor way of dealing with (and conceiving) freedom when performing welfare analysis. For him, freedom deserves the highest position when thinking about welfare. After all, the freedom to live the life one wants/has reasons to value is the core of its capability concept. So, freedom deserves close scrutiny (both theoretical and empirical) if one wants to proceed with a reliable welfare analysis.

Freedom might be thought as the concept Sen most approximates to an ultimate goal of human existence<sup>72</sup>: life expectancy at birth, school education, access to food and

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<sup>71</sup> Note, however, that in the standard pure competition model, freedom of choice is restricted to quantities since the product is homogeneous (which is a very limited conception of freedom). Only in more sophisticated models (like monopolistic competition ones), freedom to choose over quality issues becomes relevant.

<sup>72</sup> It is not by accident that Sen wrote a book entitled "Development as Freedom" where he tries to put forward the idea that true development consists in enlarging individuals' actual freedoms. Sen postulates

health, civil and political rights, etc. are all conceived as important to welfare since all contribute to enhance the freedom individuals have to choose a path for their lives.

Sen goes as far as to state that what really matters is the *actual* freedoms individuals enjoy, not the potential or legal ones (if women in a certain society have legal right to education but are systematically thrown away from school (for cultural issues) then they lack the actual freedom to study). Freedom is conceived as valuable *per se*, even if the results are not affected by its presence or absence, let those results be measured in terms of wealth, health or happiness.

Enhancing freedoms is the major political concern of SC, a primacy clearly not shared by the policies of MWE.

The HL might be thought as an intermediate position between MWE and SC as it considers freedom a very important issue on welfare (giving relevance to different forms of freedom) but not because it thinks on it as an objective value but rather because freedom usually enhances SWB. Political freedoms and civil rights, freedom to participate in economic and social life, and so on, usually show high levels of correlation with reported happiness<sup>73</sup>. That's why, there is room for policy intervention in the direction of increasing freedoms even in situations where MWE would recommend no action (because agents were supposedly maximizing their welfare and the lack of freedom was not grasped through their behaviour).

Nevertheless, HL considering freedom only as instrumental and not as a fundamental of welfare marks a sharp difference with SC. For instance, Schwartz (2002) shows that more options not always go on pair with more satisfaction. Instead, the gaining of having more options to choose from might be overcome by the increased cost of selecting the right option. The raised opportunity cost, the anguish of not knowing if we've made the best choice and the very cost of processing information might lead us to a worst situation after the options' enlargement. Within SC such fact would hardly be grasped.

From all said above it becomes clear that the choice of the framework will impinge over the policy conclusion the welfare analyst will achieve. Either we consider freedom as a precondition for market operation, as instrumental for happiness or as a

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freedom as a definite value, as an objective value, independent of whatever judgment (either social or individual) might be done about it.

<sup>73</sup> See, for instance, Frey and Stutzer (2002).

fundamental of welfare different policies will emerge as the best for welfare enhancement.

## 5.2. Income

Income might be seen as the core of WE: since the early ages of Political Economics (Smith, Ricardo, etc.) income was the main concern of Economics. Trying to understand what could promote the enlargement of national wealth was probably the first research question in the History of Economics.

From those early days to nowadays different paths have been followed in what assumptions, models and tools of analysis is concerned. Nonetheless income remained at the core of what economic welfare should be/was<sup>74</sup>.

As a consequence welfare policy has long been biased towards income enlargement neglecting all sorts of other possibly relevant issues (like environment, family life, freedom, etc.).

MWE is on pair with these ideals as it sees income as the main source of welfare and the benchmark against which all can be compared (the same is to say that everything can be translated into a monetary figure).

Forgetting the old teaching of early Neoclassics of diminishing marginal utility of money, most modern welfare polices deem GDPpc enhancement as the sole objective and uncontroversial way of increasing welfare: if I can raise the income of one person not lowering the income of any other then that income raise is good in terms of global welfare (as it is a Pareto movement).

As might be intuitively perceived this analysis neglects thousand of effects income growth policies might have on several domains of social and individual life. Those effects might be detrimental to welfare. If that's the case, the global effect of an income raise policy might be a diminished welfare.

Exactly because many welfare economists think that's the case, new approaches appeared.

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<sup>74</sup> Interestingly enough, during the classical period income was conceived as very important to welfare but not the welfare itself. So, understanding the way through which income could be raised was important as long as income itself could be transformed into welfare. Later, this "transformation problem" was forgotten as the non monetary part of welfare (ophelimity) was deemed unscientific and behind the scope of WE, see Robbins (1945). With that it became implicitly assumed that income would walk hands with hands with welfare since rational agents (that always maximize utility) with higher incomes would have the opportunity to increase their utility (welfare). So, the "transformation problem" disappeared, see Bruni (2004a, 2004b).

The advocates of HL point out four main reasons why an income raise might not be always good: *comparison effect*, *adaptation effect*, *expectations effect* and *life domains specificities*.

*Comparison effect* refer to the fact that people tend to compare their income with that of others (relevant others) so that our welfare level will mostly depend on our position relatively to others and not on its absolute level. With that, there can not be an increase in welfare (happiness) by an increase on average income: if my income rises by the same proportion as that of others then my satisfaction level will remain constant.

*Adaptation effect* refers to the fact that people tend to adapt to their current level of income, reverting to some baseline level of welfare after a while (hedonic treadmill). Again people compare themselves, now with their past, and tend to gain happiness right after an increase on their income but quickly adapt and return to their previous level of satisfaction<sup>75</sup>. Again, an income incremental policy might be extremely short lived in terms of welfare gains.

*Expectations* also play a crucial role in SWB. The *expectation effect* states that our satisfaction with any income level will be a function of the difference between our expectation and the actual level of income. So, we can only increase our welfare if our actual income level moves in the direction of our expectations. The problem is that normally our expectations will move along with our income level: for a rising income, rising expectations (in fact, this is one way of explaining the adaptation effect). If that's the case, our income oriented policy fails again<sup>76</sup>.

Finally, *life domains specificities* are crucial to complete the picture of HL in respect to income: the above cited effects are not equally present on each life domain. Specifically, satisfaction with income is the life domain most prone to adaptation and comparison: we adapt much quicker to a bigger salary than to an extended period of vacations; we compare much more the size of our house with those of the neighbours than the time we have to leisure; we adapt our expectations in term of income as it grows while our expectations of what is a good number of children doesn't change with the actual number of children we have<sup>77</sup>.

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<sup>75</sup> There is evidence of this effect even from a sample of lottery winners that quickly lost their initial euphoria and remained as happy as (or little more than) before their lucky day (see Brickman et al. (1978)).

<sup>76</sup> See Stutzer (2004) for empirical evidence on that.

<sup>77</sup> See Frank (2005).

Knowing this, it becomes simple to understand that left to themselves (via market interactions) agents will over invest in work, production and consumption (as fail to anticipate adaptation and comparison effects<sup>78</sup> and behave as addicted to consumption<sup>79</sup>) in a way that markets become inefficient in producing welfare: there are externalities (like the income of others affecting me) and imperfect rationality that destroy market efficiency.

Furthermore there are “standard” market imperfections (like environmental issues (pollution, etc.) and monopoly) that further deem market inefficient in welfare production. Nevertheless, the above described effects are the key contributions of HL.

For HL income is important as long as it is instrumental for happiness<sup>80</sup>. The policies for income must be those which promote the greater enhancement over SWB, not those which maximize income (as those are different things, as noted above).

For SC income is also a very relevant issue<sup>81</sup>. Welfare is impossible without income and its augmentation and distribution are deep concerns of this line of work.

Nevertheless we found here a severe criticism to the dogmatic importance MWE gives to income and a repositioning of income within the framework of capabilities: income is important as it is instrumental to the development of capabilities.

In order to survive, to participate in society and to flourish, every human being needs some sort of income. If he/she has not that endowment, it becomes impossible any welfare achievement.

Income is a condition *sine qua non* for welfare but it is not welfare itself. In fact, what is important is the power income brings to people so that they can transform it into capabilities<sup>82</sup>.

As in the HL case, here, the relation between income and welfare is not linear and straight clear: more income might not generate more capabilities and so more income might not always be the best there is<sup>83</sup>.

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<sup>78</sup> Note that comparison effect might be anticipated but, nonetheless, agents might be forced to act accordingly: in some situations what others have affects us directly even if one wants to stop comparing oneself with others. For instance, a student without a computer is thrown into such a deprived situation that he/she is forced to keep on the road of continuous technology adaptation, which implies continuous consumption.

<sup>79</sup> That's why decision and experienced utility diverge and a total reliance on the former causes policy mistakes.

<sup>80</sup> Remember that the graph of GDPpc over happiness (showing the diminishing marginal utility of income) might be seen as the leitmotiv for all this recent appraisal of happiness in economics.

<sup>81</sup> Sen himself have always been very concerned with poverty and deprivation and so with access to income.

<sup>82</sup> That is also why poverty, for instance, is seen as capability deprivation, not as income deprivation.



Policies that enhance GDPpc but do nothing (or do bad) to capabilities must be discarded and replaced by others, effective in enhancing capabilities. In this context, a poor but democratic country might be preferred to a wealthy dictatorship.

From all said throughout this section (and the two examples more closely analyzed) it becomes more clear why HL stands as an alternative for welfare analysis that can not be reduced to neither MWE nor SC.

HL can even be seen as a “third way” complementing capabilities and orthodoxy: share and rejects some principles of both capabilities and orthodoxy approaches but stands as an autonomous alternative. It postulates a specific set of policies and is an operational approach to WE.

## **6. Conclusion**

Throughout this paper we have analyzed three different forms of looking at WE and have tried to disclose each main postulates, assumptions and policy conclusions.

We have been able to determine that MWE, SC and HL are all different and stand as alternative and autonomous ways to perform WE analysis. In fact, although we might find some similarities between them (MWE and HL share an utilitarian, hedonistic, individualistic and consequentialist background, SC and HL share a concern with freedoms, processes and a critic to the MWE’s support of ordinal utility) their core of assumptions differ and many policy conclusion vary (mostly from MWE to SC and HL).

We have also detected that HL, being the more recent approach, suffers relatively more from internal inconsistencies and disputes. Nevertheless, it is gaining consistency, reliability (much because it appears as a very interdisciplinary field, accepting contributions of sciences like psychology, neurology, sociology, anthropology, grounding some of their assumptions on those contributions) and notoriety (as more and more papers are accepted in top ranked journals). In a word, HL is becoming a reliable approach to WE.

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<sup>83</sup> In Brazil GDPpc is much higher than in India. Nevertheless life expectancy is greater in the latter. If this was our sole data and we were using SC approach, we would be facing a dilemma when trying to rank India and Brazil in terms of welfare: both income and life expectancy are important to welfare. Using MWE, however, Brazil would be ranked first as income was all that mattered.

It was also clear that all these three approaches have different conceptions of what welfare is (due to different philosophical backgrounds). Consequently, the policy divergences between them are not just a product of divergences over which techniques are more suitable to reach a certain and common goal but a result of different conceptions on which goal is to be achieved: that is, the paths (policies) are different because the final destination (welfare conception) is not the same.

Retaining the ideas of Robbins (1981) all the three approaches analysed in this paper might be considered scientifically valid once one first decide (making a moral, non-scientific choice) which conception of welfare is to be used.

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